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SUBJECT: CZECH ELECTRICITY GIANT'S MURKY GOVERNMENT CONNECTION MEANS  
MIXED SIGNALS ON ENERGY POLICY AND PRACTICE

REF: PRAGUE 77

11. (SBU) SUMMARY AND COMMENT: Rising electricity prices, increasing demand from a robust economy, and a low cost generation fleet have led Czech electricity company CEZ Group (67.61% state owned) to become the most profitable company in the Czech Republic for the last two years. The lack of transparency in CEZ-GOCR relations and in CEZ operations, however, makes it difficult to discern where government political interests end and CEZ business interests begin.

Therefore, future CEZ capital investments and expansion are an important and often the only yard stick available for determining the direction of energy policy for the mid- to long-term. The unified message from the Czech energy industry is that nuclear generation is the only option available to the Czech Republic that reduces carbon emissions, increases energy security, and effectively meets growing domestic demand. Energy industry representatives' support for increased utilization of nuclear energy, however, runs counter to the views of the current coalition government, which includes the Green Party.

12. (SBU) SUMMARY AND COMMENT CONTINUED: CEZ is marching forward with its nuclear expansion plans without the official endorsement of the current government, its majority owner. CEZ is hedging given the weakness of the current government that throws in to question its longevity, as well as past open support for nuclear expansion from both sides of the isle (Civic Democrats -- ODS & Social Democrats -- CSSD). In fact, the Chairman and Vice Chairman of the supervisory board are either current or former members of ODS. CEZ also points out that planning for expansion of nuclear energy production requires a 20-year time line, with only the final five years involving physical construction, which means they can stick with future plans without any visual expansion. Therefore, in the absence of a more overt opposition by the government, CEZ is following industry opinion. Whoever is in government in 2019 will have to contend with whether to bring 15 years of nuclear power planning online or facing a possible power shortage. The situation may result in a state-owned company dictating policy to the government. END SUMMARY AND COMMENT.

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CEZ DOMINATES DOMESTIC AND REGIONAL MARKET  
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13. (U) CEZ is the eighth largest utility company in Europe, both in terms of customers (6.8 million) and in market capitalization (\$29.7 billion). It also has the lowest debt/EBITDA ratio (0.8) of any electrical utility in Europe and Standard & Poor's gives CEZ an A-credit rating. In 2005, CEZ dividends contributed CZK 3.6 billion (\$180 million) to the government budget and its dividend payout per share grew tenfold in six years (CZK 2 or \$.10 in 2000 to CZK 20 or \$1 in 2006). CEZ is a vertically integrated company, which means they have stakes in every facet of electricity production except for transmission, which is controlled and regulated by the GOCR. In 2006, CEZ Group companies produced 22.5 million tons of lignite coal, 46% of the country's total and 73.5% of total electricity in

the CR (62.0 TWh). They also own five of the eight distribution companies in the CR, which account for 62% of all customers.

14. (U) Regionally, CEZ owns two generation units in Poland with a combined capacity of 830 MW, distribution services in Romania reaching 1.4 million customers, distribution services in Bulgaria reaching 1.9 million customers, and generation in Bulgaria with a total capacity of 1,260 MW. They have also signed joint venture agreements to build new generation facilities in Bosnia and Herzegovina and in Russia. CEZ anticipates further economic growth in the Balkans and southern Europe and a corresponding expansion of energy use, which will raise electricity prices closer to Western European levels. This, combined with CEZ's own experience in the Czech transition economy, has motivated its enthusiastic regional expansion.

15. (SBU) CEZ has a supervisory board, half of which, including the chairman, are appointed by the government. Currently, former ODS MP Martin Kocourek is Chairman and Deputy Minister of Trade and Industry for Energy Tomas Huner (ODS) is Vice Chairman of the 12-member supervisory board. While the supervisory board must approve the actions of the board of directors, CEZ representatives could not recall a recent instance of the supervisory board overriding the board of directors. CEZ representatives stressed that CEZ's primary objective is to make money for shareholders, which it does quite well.

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WHY NUCLEAR IS THE ONLY ANSWER  
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16. (U) Given that two-thirds of CEZ thermal generation capacity is between 30-40 years old, major capital investments are needed to keep capacity running and to meet increasingly stringent EU carbon emissions standards. The amount of capital required for compliance and general maintenance of older plants is not known. However, most

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plants approaching 40 years of service need substantial upgrades, which can almost double the average cost of producing 1 MW of electricity. 2008-2014 is CEZ's timeframe for major coal asset renewal and they are estimating total costs at CZK 140 billion (\$7 billion). In light of likely capital cost increases, an uncertain regulatory climate for emissions, and increasing fuel prices, CEZ representatives believe that coal fired plants cannot be a long term solution for growing energy consumption.

17. (U) Renewable energy sources have limited applicability in the CR and are not reliable enough to satisfy the EU-mandated 12% of a country's energy portfolio by 2010. Hydro-electric power consists of just under 4% of 2006 total CEZ output. CEZ representatives state that hydro-electric resources have been maximized and that capacity cannot be expanded within the CR. Wind and solar power are not viable for significant energy production in the CR. CEZ does operate a wind farm in Southern Moravia and an experimental solar farm at Dukovany. However, these are experimental and symbolic forays into renewable energy sources. The one renewable that CEZ is utilizing to some degree of effectiveness is biomass, which is burned with coal in certain facilities. Biomass is not efficient enough to take the place of coal and the CR does not have enough land available for keeping a large sustainable biomass crop. On top of these drawbacks, furniture makers have been protesting the use of biomass because it increases the price of wood chips used in the creation of particle boards.

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RUSSIA WILL BE SOLE SUPPLIER OF NUCLEAR FUEL  
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18. (U) CEZ is banking heavily on nuclear energy to bolster its base load production in the mid-term. In 2006, nuclear generated electricity accounted for 42% of total CEZ generation (26 TWh out of 62 TWh total). Temelin and Dukovany are the two nuclear plants operating in the CR. Dukovany began operating in 1985 and Temelin came online in 2004, and both are Soviet designed reactors and will operate under current conditions until 2027 and 2042, respectively. Those dates are not firm, however, and both plants could have their life-spans extended further with appropriate legislation and

upgrades. Dukovany, which uses a type of fuel only produced in Russia and Spain, has a long term fuel contract with the Russian company TVEL. TVEL also won a recent bid to supply Temelin with fuel from 2010-2020, which Westinghouse currently supplies through 2009.

19. (SBU) Concern over complete Russian control of nuclear fuel supplies is not justified in the short-run but could be a concern in the long term. Dukovany keeps a one year reserve of fuel on site and both stations only replace 1/5 of their fuel once a year. Therefore, if Russia were to cut off nuclear fuel supplies to the CR, it would not have the same effect as gas or oil supplies. Sufficient time would be in place to negotiate with alternative fuel suppliers. Nuclear generation has large costs associated with construction, security, and waste disposal, but once built, it has a very low marginal cost, steady fuel supplies, and no carbon emissions. From the view point of public finances, energy efficiency, and emissions reductions, nuclear power makes perfect sense for CEZ and the CR. The real question, however, is whether the domestic and European political situations come to value the security and emissions benefits of nuclear over the potential hazards.

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PRAGUE POWER EXCHANGE  
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10. (SBU) In 2007, CEZ consented to create the Prague Power Exchange (PX) where it will sell roughly 30% of its capacity. The other 70% is sold directly to its subsidiaries for distribution to consumers. PX CEO David Kucera acknowledges that if CEZ did not agree to sell this capacity on the exchange, then the whole project would not have proceeded. The PX's objective is to bring transparency to the energy market by replacing an annual energy auction with an exchange that allows people to gauge electricity prices daily. Businesses will be able to view and financially secure power prices for two years out and this helps with effective planning. Industry believes popular fear of steadily increasing prices on the exchange is invalid. The previous once yearly auction increasingly involved the same percentage increase, but because it only occurred once a year, the auction and prices simply faded from memory rather than being constantly reminded with daily and even hourly price readouts. Therefore, some argue that yearly auctions actually inflate the price of electricity because firms would bid high in fear of getting frozen out of the auction allocation. The problem with the PX is that CEZ has market power because it is the largest player in the market so CEZ could manipulate this market in a variety of ways to avoid speculation. Nevertheless, the PX is a too-tempting-to-resist venue to exercise market power for CEZ profit, which happens to fill government coffers.  
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